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A Negligence Approach to Section 14(e) Violations

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A NEGLIGENCE APPROACH TO SECTION 14(E) VIOLATIONS

ABSTRACT

The tender offer is a common method used by third parties to gain control of a company. Third parties will approach a company's shareholders with the opportunity to sell their shares at a fixed price, the result being a change in ownership and control. A company's top executives may be threatened by this change in ownership and want to recommend that the shareholders reject the offer. However, executives have a duty to act in accordance with the shareholders' best interests. This may lead to a conflict between the shareholders' interests and the executives' interests. Section 14(e) of the Securities Exchange Act of 1934 is designed to ensure that tender offers are not alienated by these conflicts of interests faced by company executives, and to ensure that shareholders are given all accurate information material to the decision of whether to accept or reject the tender offer.

This Comment analyzes and critiques how circuit courts have historically taken a scienter approach to Section 14(e) claims, largely due to the appealing comparison to Rule 10b-5 and its requirements. A scienter requirement forces plaintiffs to prove that defendants acted with sufficient culpability when violating Section 14(e). This Comment proposes that courts alternatively implement a negligence standard, requiring plaintiffs to prove that defendants acted negligently in connection with a tender offer when alleging a violation of Section 14(e). A negligence standard would make it easier for a plaintiff to prove a violation of Section 14(e), which would mean an increase in claims asserted against a company's top executives. Therefore, a negligence standard would increase executives' exposure to liability, which could create positive change toward executives focusing more on the shareholders' interests than on their own interests when evaluating tender offers.

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INTRODUCTION

Imagine you own 1,000 shares of Time Warner Inc. at \$40 per share for a market valuation of \$40,000. One day, you are notified that AT&T has made a formal tender offer to buy your shares at \$55 per share but that the deal will only close if 80% of the outstanding stock is tendered to AT&T by Time Warner's stockholders as part of the transaction. You have a couple of weeks to decide whether you will tender your shares. If you decide to accept and enough shares are tendered, the transaction is completed, and you'll see the 1,000 shares of Time Warner taken out of your account and a deposit of \$55,000 cash put into it. If the tender offer fails because less than 80% of the shares were tendered to AT&T, the offer disappears and you don't sell your stock. You're left with your original 1,000 shares of Time Warner in your brokerage account.

The transaction just described is known as a tender offer. A tender offer is a broad solicitation by a third party to purchase a substantial percentage of a company's shares for a limited period of time.¹ The offer is typically at a fixed price above the current market price and is contingent on shareholders tendering a fixed number of their shares.² In the 1960s, the tender offer became a common method used by third parties to gain control of corporations. To this day, the tender offer remains a topic of contention as courts have tried to navigate the elements of a claim made by stockholders regarding the possible mishandling of a tender offer by company executives. Congress added provisions to the Securities Exchange Act of 1934 (Exchange Act) by way of the Williams Act of 1968 in response to the growing popularity of tender offers.³ The Williams Act regulates tender offers by requiring the offeror to disclose all material information relating to the tender offer and by ensuring that current shareholders have adequate time to consider the information provided before accepting or rejecting the tender offer.⁴

Section 14(e) of the Exchange Act was part of the Williams Act.⁵ The purpose of Section 14(e) is to regulate the conduct of the broad range of people who could influence the decision of company investors or the outcome of a

¹ *Fast Answers: Tender Offer*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/fast-answers/answerstenderhtm.html> (last visited Dec. 3, 2019) [hereinafter *Tender Offer*].

² *Id.*

³ *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 404 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459); *see also* Mark L. Berman, Note, *SEC Takeover Regulation Under the Williams Act*, 62 N.Y.U. L. REV. 580, 584 (1987).

⁴ Berman, *supra* note 3, at 584.

⁵ *Varjabedian*, 888 F.3d at 404.

tender offer.⁶ Thus, Section 14(e) is a broad anti-fraud provision requiring persons engaged in making or opposing tender offers to accurately disclose all material information in connection with the tender offer to the target company's shareholders.⁷

Section 14(e) generally prohibits two forms of conduct.⁸ First, the statute prohibits the making of any false statements of a material fact and the omission of any material fact necessary to make the statements made not misleading.⁹ Second, the statute prohibits "any fraudulent, deceptive, or manipulative acts or practices."¹⁰

Until 2018, when faced with the question of the correct burden of proof for Section 14(e) claims, five federal circuits had ruled that plaintiffs asserting a Section 14(e) claim were required to prove that the defendant acted with sufficient culpability, as opposed to mere negligence.¹¹ The concept of culpability is often referred to as scienter, which functions as a way of limiting the imposition of liability to persons whose conduct has been sufficiently culpable to justify the liability.¹² Each of these circuits pointed to the similar language in Rule 10b-5, which the Supreme Court ruled requires proof of scienter,¹³ in support of its holding that Section 14(e) requires scienter as well.¹⁴ A scienter standard requires a showing of intent or knowledge of the nature of one's act or omission.¹⁵ In contrast, a mere negligence standard does not require a plaintiff to prove the defendant's intentional wrongdoing.¹⁶ Thus, a scienter requirement puts a heavier burden of proof on a plaintiff than does a negligence standard.

On April 20, 2018, the Ninth Circuit created a circuit split regarding whether claims asserting violations of Section 14(e) require a showing of negligence or scienter.¹⁷ In *Varjabedian v. Emulex Corp.*, the Ninth Circuit held that a plaintiff

⁶ *Id.*

⁷ See Mark J. Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L.J. 1311, 1311 (1983).

⁸ See *Varjabedian*, 888 F.3d at 404.

⁹ 15 U.S.C. § 78n(e) (2012).

¹⁰ *Id.*

¹¹ See *infra* note 89 and accompanying text.

¹² *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir. 1973).

¹³ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

¹⁴ See *infra* Part I.B.

¹⁵ See Christopher Joseph Habenicht, Note, *A Negligence Standard for Material Misstatements and Omissions in Tender Offers Under 14(e) of the Securities Exchange Act of 1934*, 31 WASH. & LEE L. REV. 733, 740 n.33 (1974).

¹⁶ See *id.*

¹⁷ See *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 408 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____

alleging a Section 14(e) violation need only show negligence, rather than scienter.¹⁸ Because a scienter standard is a heavier burden of proof than a negligence standard, the Ninth Circuit's decision will make it easier for a plaintiff to claim a violation of Section 14(e). Additionally, the Ninth Circuit's holding potentially places a company's top executives—that is, the people who have influence over the decision to accept a tender offer—at a higher risk of these claims being asserted against them.

This Comment argues for the adoption of a negligence standard for claims asserting violations of Section 14(e), consistent with the Ninth Circuit's holding in *Varjabedian*. Part I discusses the background of Section 14(e) of the Exchange Act, the history of cases in which five circuits held that scienter was a necessary element for Section 14(e) claims, and the context of the Ninth Circuit's holding in *Varjabedian* that led to the current circuit split. Part II argues that a negligence standard under Section 14(e) is appropriate for four reasons: (1) the text of the statute suggests that it can be readily divided into two clauses, one requiring a showing of negligence and the other requiring proof of scienter; (2) the legislative history of the Williams Act evinces an intent to require less than an allegation of scienter; (3) the five circuits requiring proof of scienter inappropriately used Section 10(b) and Rule 10b-5 to interpret Section 14(e); and (4) the similarities between Section 17(a) of the Securities Act of 1933 (Securities Act) and Section 14(e) warrant extrapolation of the case law under Section 17(a) as precedent for a negligence standard. Finally, Part III discusses the potential implications, from both a legal and policy perspective, that a negligence standard would have on the judicial system and company executives. Legally, a negligence standard would make it easier for a plaintiff to prove a violation of Section 14(e), which means an increase in claims asserted against a company's top executives. From a policy standpoint, a negligence standard would place a company's top executives at a higher risk of these claims being asserted against them, which could create positive change toward executives focusing more on the shareholders' interests than on their own interests when evaluating tender offers.

I. THE DEVELOPMENT OF SECTION 14(E) IN THE LAW

Following the enactment of the Exchange Act and the creation of the Securities and Exchange Commission, Congress enacted Section 14(e) to better protect individuals and companies involved in third-party takeovers. Since its

(Apr. 23, 2019) (No. 18-459).

¹⁸ *Id.*

enactment, five federal circuits held that scienter was a necessary element for Section 14(e) claims. However, a circuit split developed following the Ninth Circuit's holding in *Varjabedian* and its subsequent implementation of a negligence standard. Before one can understand the context of the case law and the subsequent circuit split, it is important to understand the history behind Section 14(e)'s enactment. Section A of this Part walks through its history, Section B addresses the history of cases in which five circuits implemented a scienter standard, and Section C discusses the context of the Ninth Circuit's holding in *Varjabedian* that led to the current circuit split.

A. *History of Section 14(e) of the Securities Exchange Act of 1934*

Congress enacted the Securities Act and the Exchange Act in response to the Great Depression.¹⁹ The Securities Act regulates initial public offerings by companies.²⁰ To do so, the Securities Act requires that investors have access to “financial and other significant information concerning securities being offered for public sale” when evaluating whether to invest in a company.²¹ Additionally, the Securities Act prohibits deceit, misrepresentations, and other fraudulent activities in the sale of securities.²²

The primary method employed to achieve the requirements of the Securities Act and to ensure the disclosure of a company's key financial information is the registration of securities.²³ Securities sold in the United States must generally be registered.²⁴ A company seeking to sell its securities must disclose the following information through the registration process: (1) “a description of the company's properties and business,” (2) “a description of the security to be offered for sale,” (3) “information about the management of the company,” and (4) “financial statements certified by independent accountants.”²⁵ Registering companies are required to report accurate information.²⁶ If a company fails to do so, investors have recovery rights if they can prove that a company disclosed incomplete or

¹⁹ *Id.* at 403.

²⁰ *Id.* at 403–04.

²¹ *Fast Answers: The Laws that Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/answers/about-lawsshtml.html> (last visited Dec. 3, 2019) [hereinafter *The Laws*].

²² *Id.*

²³ *Id.*

²⁴ *Id.* There are exemptions to the general rule that offerings of securities must be registered. Exemptions to the registration requirement include, but are not limited to, the following: (1) private offerings to a limited number of persons; (2) offerings of limited size; and (3) intrastate offerings. *Id.*

²⁵ *Id.* The four items listed are illustrative examples of the disclosure requirements mandated by the registration process.

²⁶ *Id.*

inaccurate information of the kind discussed in this paragraph.²⁷

While the Securities Act regulates initial public offerings through the registration process, the Exchange Act regulates all subsequent securities transactions.²⁸ With the Exchange Act, Congress created the Securities and Exchange Commission (SEC) and granted it “broad authority over all aspects of the securities industry.”²⁹ The Exchange Act also “identifies and prohibits certain types of conduct in the markets and provides the [SEC] with disciplinary powers over regulated entities and persons associated with them.”³⁰

Congress added provisions to the Exchange Act by way of the Williams Act of 1968.³¹ Congress enacted the Williams Act in response to the growing use of cash tender offers as a way of acquiring control of public companies.³² A tender offer is “a broad solicitation by a company or a third party to purchase a substantial percentage of a company’s Section 12 registered equity shares or units for a limited period of time.”³³ Put simply, a tender offer is one of many methods employed to gain control of a company by buying a certain amount of shares from the company’s current shareholders. The offer is typically at a fixed price above the current market price and is contingent on shareholders tendering a fixed number of their shares or units.³⁴

The Williams Act focuses on disclosure and is designed to protect investors approached with a tender offer.³⁵ Congress aimed to achieve this goal by requiring full disclosure by the offeror and ensuring that investors have adequate time to consider the disclosed information before being subjected to pressure to tender their shares.³⁶ In *Piper v. Chris-Craft Industries, Inc.*, the Supreme Court stated that the Williams Act “was styled as a disclosure provision: A bill to provide for full disclosure of corporate equity ownership”³⁷ Accordingly, the Williams Act is designed to ensure that a target company’s shareholders

²⁷ *Id.*

²⁸ *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 404 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459).

²⁹ *The Laws*, *supra* note 21.

³⁰ *Id.*

³¹ *Varjabedian*, 888 F.3d at 404.

³² Berman, *supra* note 3, at 584.

³³ *Tender Offer*, *supra* note 1.

³⁴ *Id.*

³⁵ *See Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Sec. of the S. Comm. on Banking & Currency*, 90th Cong. 1 (1967) (“[The Williams Act] is necessary for investor protection.”); Berman, *supra* note 3, at 583–85; *see also* *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 35 (1977) (“[T]he sole purpose of the Williams Act [is] the protection of investors . . .”).

³⁶ Berman, *supra* note 3, at 584.

³⁷ *Piper*, 430 U.S. at 27.

evaluating a tender offer are not required to respond to the offer without adequate information.³⁸

Congress adopted a market approach for regulating tender offers, meaning that it allows shareholders in the marketplace to define the fairness of tender offers to shareholders themselves rather than applying legislative or court-imposed principles of fairness.³⁹ Hence, the Williams Act does not impose on the courts the task of evaluating the substantive fairness of a tender offer.⁴⁰ The Supreme Court affirmed this market approach towards regulating tender offers in *Schreiber v. Burlington Northern, Inc.*⁴¹ There, the Supreme Court held that the sole objective of the Williams Act was full and fair disclosure of material information to the target corporation's shareholders.⁴² The Supreme Court refused to interpret the Williams Act as allowing courts to evaluate the substantive fairness of tender offers, noting that "the quality of any offer is a matter for the marketplace."⁴³ Thus, once a court determines that an offeror fully and accurately disclosed information material to the tender offer, the court's role is complete, and the shareholders ultimately decide if the terms and price of the tender offer are fair based on the information disclosed.⁴⁴

Consistent with the market approach adopted in the Williams Act, "Congress expressly granted the SEC broad regulatory powers to prescribe disclosure requirements applicable to large-scale accumulations of stock, third-party tender offers, and issuer purchases of their own stock, as the SEC finds 'necessary or appropriate in the public interest or for the protection of investors.'"⁴⁵ The five sections of the Williams Act require either "the disclosure of specific information or empowers the [SEC] to require the disclosure of information it deems necessary for the protection of investors."⁴⁶

The focus of this Comment will be on Section 14(e) of the Exchange Act, as added by the Williams Act, which is a broad anti-fraud provision requiring persons engaged in making or opposing tender offers to accurately disclose all

³⁸ Berman, *supra* note 3, at 585.

³⁹ *Id.* at 584; *see* *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 12 (1985) ("[T]he quality of any offer is a matter for the marketplace."); H.R. REP. NO. 90-1711, at 3-4 (1968), *as reprinted in* 1968 U.S.C.C.A.N. 2811, 2813 ("This bill is designed to make the relevant facts known so that shareholders have a fair opportunity to make their decision [in response to a tender offer].").

⁴⁰ *See* *Schreiber*, 472 U.S. at 11-12.

⁴¹ *Id.*

⁴² *Id.* at 9.

⁴³ *Id.* at 11-12.

⁴⁴ *See id.*

⁴⁵ Berman, *supra* note 3, at 585 (quoting 15 U.S.C. § 78m(d)(1) (2012)).

⁴⁶ *Id.*

material information to the target company's shareholders.⁴⁷ Section 14(e) states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.⁴⁸

Section 14(e) of the Exchange Act has three functions. First, Section 14(e) prohibits the making of false or misleading statements;⁴⁹ second, it prohibits "fraudulent, deceptive, or manipulative acts or practices";⁵⁰ and third, the SEC is authorized under Section 14(e) to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."⁵¹

The first clause of Section 14(e) prohibits the making of false or misleading statements of a material fact by any party in connection with a tender offer.⁵² The plain language of the statute "does not require that the prohibited statements or omissions be made knowingly or with the intent to deceive or defraud."⁵³ In other words, there is no explicit requirement that plaintiffs must prove that the defendant acted with sufficient culpability in connection with a tender offer when alleging a violation of Section 14(e).⁵⁴ The concept of culpability, referred to as scienter, requires some level of knowing or intentional deceit, which amounts to more than mere negligence.⁵⁵

⁴⁷ Loewenstein, *supra* note 7, at 1311.

⁴⁸ § 78n(e).

⁴⁹ *Id.* The language of this part of Section 14(e) is nearly identical to the second clause of Rule 10b-5 and to Section 17(a)(2) of the Securities Act. *Compare id.*, with 17 C.F.R. § 240.10b-5(b) (2018), and 15 U.S.C. § 77q(a)(2).

⁵⁰ 15 U.S.C. § 78n(e). The language of this part of Section 14(e) is similar to the first and third clause of Rule 10b-5 and to Sections 17(a)(1) and 17(a)(3) of the Securities Act. *Compare id.*, with 17 C.F.R. § 240.10b-5(a), (c), and 15 U.S.C. § 77q(a)(1), (3).

⁵¹ § 78n(e).

⁵² *Id.*

⁵³ Loewenstein, *supra* note 7, at 1331.

⁵⁴ *See id.*

⁵⁵ *See* *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir. 1973).

In the absence of a scienter requirement, some have argued that a mere negligence standard, which requires no intent to deceive, would be the appropriate standard under Section 14(e).⁵⁶ The Supreme Court has yet to resolve this dispute. In fact, it complicated the issue with two conflicting opinions, one regarding SEC-promulgated Rule 10b-5 and the other involving Section 17(a) of the Securities Act, both of which contain nearly identical language to Section 14(e).

Rule 10b-5 was promulgated pursuant to the authority granted to the SEC by Congress under Section 10(b) of the Exchange Act.⁵⁷ Section 10(b) and Rule 10b-5 regulate the conduct of both buyers and sellers⁵⁸ since they regulate “the purchase or sale of any security.”⁵⁹ The statute and the rule were enacted when Congress determined that self-regulation by the stock exchanges was inadequate to protect investors in the purchase or sale of securities.⁶⁰ Each provides that “any person who unlawfully manipulates the price of a security ... shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement.”⁶¹

In contrast to Section 10(b) and Rule 10b-5, Section 17(a) of the Securities Act only controls the conduct of sellers⁶² because it regulates only “the offer or sale of any securities.”⁶³ Much like Section 14(e), this statute was designed to ensure complete and accurate disclosures and statements made in connection with an offer of securities.⁶⁴ The difference between Section 17(a) and Section 14(e) boils down to the flavor of transaction each regulates—the former regulates initial public offerings, and the latter regulates tender offers.⁶⁵

Many courts tend to cite cases involving violations of Section 10(b)/Rule 10b-5 when interpreting Section 14(e). This is in large part due to the nearly identical language between the rule and the statute. In fact, Section 14(e) of the Exchange Act, Rule 10b-5, and Section 17(a) of the Securities Act each appear

⁵⁶ See Loewenstein, *supra* note 7, at 1331; Habenicht, *supra* note 15, at 735.

⁵⁷ See § 78j(b) (“It shall be unlawful for any person ... [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... [,] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” (emphasis added)).

⁵⁸ Aaron v. SEC, 446 U.S. 680, 687 (1980).

⁵⁹ 15 U.S.C. § 78j(b) (emphasis added); 17 C.F.R. § 240.10b-5 (2018) (emphasis added).

⁶⁰ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 204 (1976).

⁶¹ *Id.* at 205–06.

⁶² Aaron, 446 U.S. at 687.

⁶³ § 77q(a) (emphasis added).

⁶⁴ Varjabedian v. Emulex Corp., 888 F.3d 399, 406 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459).

⁶⁵ *Id.*

to prohibit two forms of conduct, one being false or misleading statements of a material fact and the other being fraudulent acts. The following chart illustrates the similar language between these statutes and the rule. The first row in the chart represents the portion of each provision that indicates a negligence standard,⁶⁶ and the second row represents the portion that appears to mandate a scienter requirement.⁶⁷

Standard	Section 14(e) of the Exchange Act	Rule 10b-5	Section 17(a) of the Securities Act
Negligence	It shall be unlawful . . . to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made . . . not misleading . . . in connection with any tender offer	It shall be unlawful . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading . . . in connection with the purchase or sale of any security.	It shall be unlawful . . . in the offer or sale of any securities . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made . . . not misleading
Scienter	It shall be unlawful . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer.	It shall be unlawful . . . to employ any device, scheme, or artifice to defraud, . . . or to engage in any . . . practice . . . which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.	It shall be unlawful . . . in the offer or sale of any securities . . . to employ any device, scheme, or artifice to defraud, or . . . to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Beyond their similar language, it may be appropriate to place precedential weight on cases involving violations of Section 10(b)/Rule 10b-5 and Section 17(a) based on the relationship between the Securities Act and the Exchange Act. The Securities Act and the Exchange Act “constitute interrelated components of the federal regulatory scheme governing transactions in securities.”⁶⁸ The Supreme Court has said that “the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen”⁶⁹

However, the interrelationship between these securities laws is not a controlling factor that mandates interpreting the statutes in the same way.⁷⁰ There are differences between these statutes and the rule that must be considered when interpreting Section 14(e). Take the use of the word “fraudulent” in the second clause of Section 14(e) as an example. The word “fraudulent” does not

⁶⁶ § 78n(e) (emphasis added); 17 C.F.R. § 240.10b-5(b) (2018) (emphasis added); § 77q(a)(2) (emphasis added).

⁶⁷ § 78n(e) (emphasis added); 17 C.F.R. § 240.10b-5(a), (c) (emphasis added); § 77q(a)(1), (3) (emphasis added).

⁶⁸ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 727–30 (1975)).

⁶⁹ *Id.* (quoting SEC v. Nat'l Sec., Inc., 393 U.S. 453, 466 (1969)).

⁷⁰ *See id.* at 207.

appear in Section 10(b) of the Exchange Act.⁷¹ Instead, the first clause of Rule 10b-5 prohibits the use of “any device, scheme, or artifice to defraud,” and the third clause of Rule 10b-5 prohibits “any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person”⁷² It may be that Congress intended to expand the types of activities prohibited in connection with tender offers beyond Section 10(b)’s prohibition against “manipulative or deceptive device[s]”⁷³ by including the word “fraudulent”⁷⁴ in Section 14(e).⁷⁵ The Supreme Court has held that an element of deception must be present for a cause of action to be stated under Section 10(b) and Rule 10b-5.⁷⁶ Consequently, commentators have argued that “a fraud can occur in the absence of a deception, so that a cause of action under Section 14(e) might be premised on conduct that did not include a deception.”⁷⁷

Supreme Court case law further muddies the water. On the one hand, the Supreme Court held in *Ernst & Ernst v. Hochfelder* that Rule 10b-5 requires proof of scienter,⁷⁸ which has caused lower courts to similarly require plaintiffs in Section 14(e) private actions to prove scienter.⁷⁹ Yet, on the other hand, the Supreme Court held in *Aaron v. SEC* that Section 17(a)(2), which prohibits false or misleading statements, does not require proof of scienter.⁸⁰ Based on the similar language illustrated in the chart above, the Supreme Court’s holding in *Aaron* suggested that scienter may not be a necessary element if the violation of Section 14(e) is premised on a false or misleading statement. However, neither *Hochfelder* nor *Aaron* resolved the question within the Section 14(e) context because additional factors must be considered, including the legislative history of the Williams Act, the relation of Section 14(e) to other sections of the Securities Act and the Exchange Act, and any policy considerations in determining the elements of a Section 14(e) cause of action.⁸¹

In addition to prohibiting certain acts, Congress also granted the SEC the power to define acts that are “fraudulent, deceptive, or manipulative” and to prevent these acts under Section 14(e).⁸² Pursuant to the powers granted to it

⁷¹ See § 78j(b).

⁷² Compare 15 U.S.C. § 78j(b), with 17 C.F.R. § 240.10b-5 (2018).

⁷³ § 78j(b).

⁷⁴ § 78n(e).

⁷⁵ See Loewenstein, *supra* note 7, at 1331.

⁷⁶ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977).

⁷⁷ *E.g.*, Loewenstein, *supra* note 7, at 1331–32.

⁷⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

⁷⁹ See *infra* Part I.B.

⁸⁰ *Aaron v. SEC*, 446 U.S. 680, 696 (1980).

⁸¹ Loewenstein, *supra* note 7, at 1331. For analysis of these further considerations, see *infra* Parts II–III.

⁸² 15 U.S.C. § 78n(e) (2012).

under Section 14(e), the SEC has promulgated a number of rules to prevent fraudulent, deceptive, or manipulative behavior in connection with a tender offer.⁸³ Among those rules promulgated under Section 14(e) is Rule 14e-3, which generally prohibits trading on nonpublic information regarding tender offers.⁸⁴ Scholars have argued that Rule 14e-3 also prohibits trading activities permissible under Rule 10b-5,⁸⁵ once again illustrating the broader scope of Section 14(e) as opposed to Section 10(b) and Rule 10b-5.

As previously discussed, Section 14(e) can be readily divided into two clauses prohibiting two forms of conduct.⁸⁶ First, the statute prohibits the making of any false statements of a material fact and the omission of any material fact necessary to make the statements made not misleading.⁸⁷ Second, the statute prohibits “any fraudulent, deceptive, or manipulative acts or practices.”⁸⁸ The key issue in interpreting Section 14(e) turns on whether plaintiffs asserting a violation of Section 14(e) are required to show the defendant acted with scienter or negligence. Before the most recent holding in *Varjabedian*, five circuits held that the correct standard in a Section 14(e) analysis is one of scienter.

B. Five Circuits Require Scienter for Section 14(e) Claims

Between 1973 and 2004, the Second, Third, Fifth, Sixth, and Eleventh Circuits all held that the correct standard of analysis for Section 14(e) claims was one of scienter.⁸⁹ In 1973, the Second Circuit became the first circuit to address the underlying principles governing liability under Section 14(e) in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*⁹⁰ In *Chris-Craft*, Chris-Craft Industries (CCI) informed Piper Aircraft Corporation that CCI would be announcing a cash tender offer for the purchase of Piper stock and that CCI had tentative plans to acquire a majority shareholder interest in Piper.⁹¹ After a

⁸³ See, e.g., 17 C.F.R. § 240.14e-1 (2018).

⁸⁴ *Id.* § 240.14e-3.

⁸⁵ See, e.g., Loewenstein, *supra* note 7, at 1332.

⁸⁶ *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 404 (9th Cir. 2018), *cert. dismissed* 586 U.S. ___ (Apr. 23, 2019) (No. 18-459).

⁸⁷ § 78n(e).

⁸⁸ *Id.*

⁸⁹ See *In re Dig. Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *SEC v. Ginsburg*, 362 F.3d 1292, 1297 (11th Cir. 2004); *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 431 (6th Cir. 1980); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir. 1973).

⁹⁰ See *Chris-Craft Indus.*, 480 F.2d at 362.

⁹¹ *Id.* at 351. In a statement released to the press on January 23, 1969, CCI announced a cash tender offer beginning immediately and ending on February 3 for up to 300,000 shares of Piper at \$65 per share. *Id.* The

meeting with Piper management, Piper decided to oppose CCI's bid for control of the corporation.⁹² A contest for control of Piper later ensued between CCI and other companies approached by Piper management.⁹³ Ultimately, CCI lost the battle for control of Piper even though it had invested \$44 million in purchasing Piper stock.⁹⁴ CCI brought an action against Piper management, alleging they had violated Section 14(e) when Piper publicly stated that CCI's tender offer was inadequate, among other assertions.⁹⁵

When interpreting the elements of Piper's Section 14(e) claim, the court in *Chris-Craft* identified Rule 10b-5 as being nearly identical to the language of Section 14(e).⁹⁶ The court made one key distinction between the rule and the statute—Rule 10b-5 is applicable to “the purchase or sale of any security,” while Section 14(e) is applicable to “any tender offer ... or any solicitation of security holders in opposition to ... any such offer”⁹⁷ Therefore, the court followed the same principles of a Rule 10b-5 analysis, holding that “a violation of Section 14(e) is shown when there has been a *material* misrepresentation or omission concerned with a tender offer and when such misstatement or omission was *sufficiently culpable* to justify granting relief to the injured party.”⁹⁸

Notably, this is the first time a court introduced culpability, or scienter, into

price of Piper stock on the NYSE at the close of January 22 was \$52.50. *Id.* This is illustrative of the definition of a cash tender offer as defined in Part I.A of this Comment.

⁹² *Id.* Piper resisted CCI's tender offer in several forms. Piper's board of directors adopted a resolution that CCI's offer was not in the best interests of the Piper shareholders. *Id.* Letters were sent out the same day asking Piper shareholders to delay accepting the CCI offer until the Piper management could adequately respond to it. *Id.* A second letter was sent to Piper's shareholders, stating that Piper's board of directors have “carefully studied this offer and [are] convinced that it is inadequate and not in the best interests of Piper's shareholders.” *Id.*

⁹³ *See id.* at 351–54.

⁹⁴ *Id.* at 354.

⁹⁵ *Id.* at 355.

⁹⁶ Compare 15 U.S.C. § 78n(e) (2012), with 17 C.F.R. § 240.10b-5 (2018). Rule 10b-5 was promulgated pursuant to the authority granted to the SEC by Congress under Section 10(b) of the Exchange Act:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

§ 240.10b-5.

⁹⁷ *Chris-Craft Indus.*, 480 F.2d at 362.

⁹⁸ *Id.* (emphasis added).

the Section 14(e) analysis.⁹⁹ The concept of culpability functions as a way of limiting the imposition of liability to persons whose conduct has been sufficiently culpable to justify the liability.¹⁰⁰ In determining what constitutes sufficient culpability in the Section 14(e) context, the court in *Chris-Craft* considered the major congressional policy behind the securities laws and the obligations of key players in a tender offer toward the target corporation's investors.¹⁰¹ The major congressional policy behind the securities laws is "the protection of investors who rely on the completeness and accuracy of information made available to them."¹⁰² Officers of a target corporation have greater access to information than do investors, which gives rise to an obligation to disclose any "material facts about which the investor is presumably uninformed and which would, in reasonable anticipation, affect his judgment."¹⁰³ Because of this duty to disclose, the court concluded that a knowing or reckless failure to discharge these obligations constitutes sufficiently culpable conduct in violation of Section 14(e).¹⁰⁴ More specifically, the court announced the following standard for determining liability under Section 14(e):

[T]he standard for determining liability under § 14(e) on the part of a person making a misleading tender offer, or a responsible officer of a corporation making such an offer, is whether plaintiff has established that defendant either (1) *knew* the material facts that were misstated or omitted, or (2) *failed or refused to ascertain* such facts when they were available to him or could have been discovered by him with reasonable effort.¹⁰⁵

The court, therefore, held that Piper violated Section 14(e) when it publicly announced that it believed CCI's tender offer was inadequate through a press release and through letters sent to its shareholders.¹⁰⁶

⁹⁹ The court noted similarities between tender offers and proxy contests as they relate to the concept of culpability. *Id.* at 362 n.14. Pointing out that a tender offer is like a contest, participants on both sides act quickly, impulsively, often in anger and under the stress of the marketplace. *Id.* (quoting *Elec. Specialty Co. v. Int'l Controls Corp.*, 409 F.2d 937, 948 (2d Cir. 1969)). These inherent characteristics of a tender offer, along with Congress's limited intentions to only assure basic honesty and fair dealing, should be considered when evaluating the party's conduct. *Id.* (quoting *Elec. Specialty Co.*, 409 F.2d at 948).

¹⁰⁰ *Id.* at 363.

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 364 (emphasis added).

¹⁰⁶ *Id.* at 366. The court supported its holding by discussing what a reasonable shareholder would have assumed by Piper's use of the term "inadequate." The court stated that a reasonable shareholder would assume that the term "inadequate" referred to price. *Id.* at 364. However, at that time Piper stock was selling on the market for \$52.50, while the tender offer was for \$65 per share. *Id.* at 351. Thus, the court concluded that Piper's statement was materially misleading to its shareholders because Piper knew that its shareholders would rely on

The Second Circuit reaffirmed its stance on the scienter requirement for Section 14(e) claims in *Connecticut National Bank v. Fluor Corp.*¹⁰⁷ To have a successful action under Section 14(e), the court held that a “plaintiff must plead and prove ‘an intent to defraud,’ ‘knowledge of falsity,’ or a ‘reckless disregard for the truth.’”¹⁰⁸ Proof of negligent conduct would not suffice to maintain a Section 14(e) claim.¹⁰⁹ Expanding on the requirements of a Section 14(e) claim, the court also held that the plaintiff’s allegations of scienter do not require great specificity, but rather “a minimal factual basis ... which give[s] rise to a strong inference” that the defendants acted with the necessary scienter.¹¹⁰

The Fifth Circuit followed the Second Circuit’s lead regarding the necessary elements for determining liability under Section 14(e) in the 1974 case *Smallwood v. Pearl Brewing Co.*¹¹¹ In *Smallwood*, Pearl Brewing Company’s board of directors approved a merger agreement between Pearl and Southdown, Inc.¹¹² Pearl sent a press release and cover letter to its shareholders, describing certain provisions of the merger agreement between the two companies.¹¹³ Among these provisions described in the press release was a condition to Pearl’s obligation to close; that is, Southdown was required to obtain an underwriting commitment affording the former Pearl stockholders the opportunity to sell up to 45% of the Southdown preferred stock they received in the merger.¹¹⁴ Although the merger agreement granted Pearl’s board of directors the power to waive the underwriting commitment, the press release did not mention this power.¹¹⁵ To implement this sell-out provision, Southdown mailed a cover letter to Pearl’s shareholders, which the court ruled was a “request or invitation for tenders,” that is, a tender offer covered by Section 14(e).¹¹⁶ Smallwood received this offer as Pearl’s shareholder.¹¹⁷ Smallwood filed actions against Pearl and Southdown, alleging in part that Southdown’s letter to Pearl’s shareholders omitted several material facts—thus, violating Section 14(e)—including that the merger could be consummated without an underwriting agreement.¹¹⁸

this representation. *Id.* at 364–65.

¹⁰⁷ See 808 F.2d 957, 961 (2d Cir. 1987) (“It is well settled in this Circuit that scienter is a necessary element of a claim for damages under § 14(e) of the Williams Act.”).

¹⁰⁸ *Id.* (quoting *Chris-Craft Indus.*, 480 F.2d at 363).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 962.

¹¹¹ 489 F.2d 579, 605 (5th Cir. 1974).

¹¹² *Id.* at 585.

¹¹³ *Id.* at 586.

¹¹⁴ *Id.* The merger agreement was later attached as an exhibit to a proxy statement. *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 586–87, 597.

¹¹⁷ *Id.* at 588.

¹¹⁸ *Id.*

Agreeing with the Second Circuit, the Fifth Circuit held that the same elements required to establish a violation of Rule 10b-5 must be proved to establish a violation of Section 14(e).¹¹⁹ In dicta, the court noted that although under common law plaintiffs were required to prove scienter, the federal courts had taken a more liberal approach to the necessary elements for violations of Rule 10b-5.¹²⁰ However, the court further noted that “liability in a private action for damages has apparently never been imposed for negligent conduct under the Rule.”¹²¹ Thus, the court held that some culpability beyond mere negligence is required for Rule 10b-5 claims and consequently for Section 14(e) claims.¹²² The court did not rule on the degree of scienter required because the plaintiffs in the case failed to establish that the defendants acted with any culpability.¹²³

Beyond ruling that Section 14(e) requires proof that the defendant acted with some culpability, *Smallwood* also attempted to shed light on the disclosure requirements demanded by the Williams Act.¹²⁴ The court rejected the assertion that prior disclosure in one communication to company shareholders will automatically excuse omissions in another communication.¹²⁵ The court noted that the “adequacy of disclosure is a function of position, emphasis, and the reasonable anticipation that certain future events will occur. Perception of future events may take on a different cast as the future approaches, and, what is more important, later correspondence may act to bury facts previously disclosed.”¹²⁶ Hence, to protect company shareholders, the elements must be weighed each time that the shareholders are requested (or encouraged) to make a new decision.¹²⁷ However, the court noted that its ruling does not mean that “a material fact must be disclosed in each communication or be repeated before each shareholder decision in order to avoid a violation of the securities laws.”¹²⁸ The point being the adequacy of disclosure must be measured based on a totality-

¹¹⁹ *Id.* at 605 (“Congress adopted in Section 14(e) the substantive language of the second paragraph of Rule 10b-5 and in so doing accepted the precedential baggage those words have carried over the years.”).

¹²⁰ *Id.* at 606.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *See id.* at 605.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* at 605–06 (citing *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 365 n.18 (2d Cir. 1973)).

¹²⁸ *Id.* at 606 (“Facts may be adequately disclosed by emphasis or repetitions in previous correspondence by the same parties or through outside sources.”). For example, in *Johnson v. Wiggs*, the Fifth Circuit held that information reported in the newspapers and on television and readily available in any brokerage house was sufficiently in the public domain; the defendant did not need to disclose that which had been publicly proclaimed in several ways on several occasions. 443 F.2d 803, 806 (5th Cir. 1971).

of-the-circumstances, case-by-case approach.¹²⁹

The Fifth Circuit ultimately reaffirmed the Second Circuit's holding that scienter is a necessary element of Section 14(e) claims in 2009 with *Flaherty & Crumrine Preferred Income Fund Inc. v. TXU Corp.*¹³⁰ In *Flaherty*, the court held that both Section 10(b) and Section 14(e) of the Exchange Act require the plaintiff to allege "(1) a misstatement or an omission (2) of a material fact (3) made with scienter (4) on which the plaintiffs relied (5) that proximately caused the plaintiff's injury."¹³¹ In the securities fraud context, scienter constitutes "an intent to deceive, manipulate, or defraud" or "that severe recklessness in which the danger of misleading buyers or sellers is either known to the defendant or is so obvious that the defendant must have been aware of it."¹³² The court ruled that "severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve ... an extreme departure from the standards of ordinary care."¹³³ Thus, ordinary negligence does not meet the requirements of Section 14(e) claims in the Fifth Circuit.

In 1980, the Sixth Circuit joined the Second and Fifth Circuits in declaring that Section 14(e) claims require proof of scienter in *Adams v. Standard Knitting Mills, Inc.*¹³⁴ In *Adams*, Chadbourn, Inc. acquired all of the common stock of Standard Knitting Mills, Inc. after Standard's stockholders agreed to exchange their stock for a package of Chadbourn's common and preferred stock.¹³⁵ Prior to this transaction, Standard sent its shareholders a proxy statement containing a recommendation by Standard's management favoring the proposed merger between the two companies and Chadbourn's financial statements prepared by its accountants, Peat Marwick.¹³⁶ Chadbourn had previously entered into loan agreements, which placed certain restrictions on the use of retained earnings for the payment of dividends to shareholders.¹³⁷ These restrictions applied to the payment of dividends on the capital stock of any class, including preferred stock.¹³⁸ Chadbourn's financial statements prepared by Peat and attached to the proxy statement provided to Standard's shareholders erroneously stated that the

¹²⁹ See *Smallwood*, 489 F.2d at 606.

¹³⁰ 565 F.3d 200, 207 (5th Cir. 2009) ("The elements of a claim under Section 14(e), which applies to tender offers, are identical to the Section 10(b)/Rule 10b-5 elements." (citing *Smallwood*, 489 F.2d at 605)).

¹³¹ *Id.* (emphasis added) (citing *R2 Invs. LDC v. Phillips*, 401 F.3d 638, 641 (5th Cir. 2005)).

¹³² *Id.* (quoting *Phillips*, 401 F.3d at 643).

¹³³ *Id.* (quoting *Phillips*, 401 F.3d at 643).

¹³⁴ 623 F.2d 422, 431 (6th Cir. 1980).

¹³⁵ *Id.* at 424.

¹³⁶ *Id.*

¹³⁷ *Id.* at 425.

¹³⁸ *Id.*

restrictions only applied to the payment of dividends on common stock.¹³⁹ About a year after the merger, Chadbourn's sales unexpectedly dropped, which caused a significant loss that wiped out its retained earnings and left it with a capital deficit.¹⁴⁰ Chadbourn was unable to pay dividends on its preferred stock.¹⁴¹ Standard's shareholders filed a class action against Peat, alleging that the accounting firm's mistake in the financial statements amounted to false proxy solicitation in an effort to gain shareholder approval of the merger between Chadbourn and Standard.¹⁴²

The court found Peat's failure to point out that the restrictions on the payment of dividends by Chadbourn applied to all capital stock was due to mere negligence.¹⁴³ Although the plaintiffs brought causes of action under Section 10(b) and Section 14(a), the court used the standard of liability imposed on Section 14(e) claims when evaluating the claim under Section 14(a).¹⁴⁴ The court referred to the language of the Williams Act and the Supreme Court case *Ernst & Ernst v. Hochfelder* to justify its holding that scienter is an element of Section 14(e) claims.¹⁴⁵ In *Hochfelder*, the Supreme Court held that a plaintiff must allege scienter—intent to deceive, manipulate, or defraud—when bringing a cause of action for damages under Section 10(b) and Rule 10b-5.¹⁴⁶ Accordingly, in *Adams*, the court ruled that Congress's use of the words “fraudulent,” “deceptive,” and “manipulative” in Section 14(e) indicated that

¹³⁹ *Id.* Footnote 7 in the financial statements erroneously described the restriction as follows:

As to the note payable to three banks, [Chadbourn] has agreed to various restrictive provisions including those relating to maintenance of minimum stockholders' equity and working capital, the purchase, sale or encumbering of fixed assets, insurance (sic) of indebtedness, the leasing of additional assets and the payment of dividends on common stock in excess of \$ 2,000,000 plus earnings subsequent to August 2, 1969.

Id. at 426 (emphasis added).

¹⁴⁰ *Id.* at 425.

¹⁴¹ *Id.*

¹⁴² *Id.* at 424–25.

¹⁴³ *Id.* at 426.

¹⁴⁴ *Id.* at 431. The court referred to the House Report for the Williams Act to justify its use of the Section 14(e) standard of liability in this context, which stated in part that “[t]he cash tender offer is similar to a proxy contest, and the committee could find no reason to continue the present gap in the Federal securities laws which leaves the cash tender offer exempt from disclosure provisions.” *Id.* at 430 (quoting H.R. REP. NO. 90-1711 at 3 (1968), as reprinted in 1968 U.S.C.A.N. 2811, 2813). The court noted that tender offers and proxy solicitations are two methods designed to get to the same conclusion—corporate control—and thus are both subject to the same type of abuse by corporate officers and the like. *Id.* Thus, Congress enacted the Williams Act to ensure both methods were subject to the same disclosure requirements. See *infra* Part II.B.

¹⁴⁵ *Adams*, 623 F.2d at 431. *Hochfelder* involved causes of action under Section 10(b) and Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 187–88 (1976).

¹⁴⁶ *Hochfelder*, 425 U.S. at 193.

Section 14(e) requires scienter based on the *Hochfelder* holding.¹⁴⁷ As such, the court ruled in favor of Peat since it found no intent behind Peat's error.¹⁴⁸

The Third Circuit was next to address the elements of a Section 14(e) claim in the 2004 case *In re Digital Island Securities Litigation*.¹⁴⁹ There, Digital Island, Inc. and Cable & Wireless, PLC (C&W) executed a merger agreement that involved C&W tendering an offer to purchase Digital Island's shares from its current shareholders, followed by a merger.¹⁵⁰ Digital Island's shareholders filed a class action alleging violations of Section 14(e) based on two significant business deals that were announced immediately after the expiration of the tender offer.¹⁵¹ The plaintiffs alleged that both deals added value to the company that would have substantially influenced the shareholders' decision to tender their shares if the deals were disclosed.¹⁵² Further, the plaintiffs alleged that the defendants knew of the business deals prior to the expiration of the tender offer, but "deliberately or recklessly failed to disclose the deals until after the expiration of the tender offer."¹⁵³ Thus, the plaintiffs alleged that the defendants violated Section 14(e) by making misleading statements and failing to disclose material information in connection with the tender offer.¹⁵⁴

In holding that "scienter is an element of a Section 14(e) claim," the Third Circuit echoed the analysis articulated by the Second Circuit.¹⁵⁵ The court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."¹⁵⁶ Like other circuits, the Third Circuit court noted that Section 14(e) is "modeled on the antifraud provisions of § 10(b) of the [Exchange] Act and

¹⁴⁷ *Adams*, 623 F.2d at 431 ("Although *Ernst & Ernst* was decided several years after the enactment of 14(e), we are bound by its holding that Congress intends scienter when it uses [the words fraudulent, deceptive, and manipulative].").

¹⁴⁸ *Id.* at 428.

¹⁴⁹ 357 F.3d 322, 328 (3d Cir. 2004).

¹⁵⁰ *Id.* at 326.

¹⁵¹ *Id.* First, Digital Island announced a major business agreement with Bloomberg LP. *Id.* Second, Digital Island announced another major business agreement with Major League Baseball (MLB). *Id.*

¹⁵² *Id.*

¹⁵³ *Id.* The plaintiffs alleged that Digital Island's board of directors suppressed the Bloomberg and MLB deals to ensure the success of the tender offer and the subsequent merger. *Id.* When the tender offer succeeded, the merger "cashed out various options to purchase shares of common stock as well as shares of restricted common stock held by the Directors." *Id.* at 329. The plaintiffs argued that the prospect of cashing out these holdings "induced the Directors to suppress information that would have raised the value of Digital Island's shares." *Id.* This increase allegedly would have jeopardized the merger because shareholders would not have tendered their shares at \$3.40. *Id.*

¹⁵⁴ *Id.* at 324–25.

¹⁵⁵ *Id.* at 328.

¹⁵⁶ *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)).

Rule 10b-5,”¹⁵⁷ which both require proof of scienter.¹⁵⁸ The court noted that in the past, it had construed Section 14(e) and Rule 10b-5 consistently because of their similarities in both language and scope.¹⁵⁹

Digital Island also addressed the enactment of the Private Securities Litigation Reform Act of 1995 (PSLRA), which established a heightened pleading requirement for certain securities fraud cases.¹⁶⁰ The PSLRA requires plaintiffs to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁶¹ In the Section 14(e) context, the PSLRA requires plaintiffs alleging violations of Section 14(e) to “plead facts ‘with particularity,’ and these facts must give rise to a ‘strong inference’ of a knowing or reckless misstatement.”¹⁶²

Digital Island detailed two ways in which plaintiffs can meet the threshold mandated by the PSLRA.¹⁶³ First, plaintiffs may establish scienter with facts that show a motive and an opportunity to commit fraud.¹⁶⁴ In *Digital Island*, the court ruled that the plaintiff’s inference of motive rested on an assumption devoid of any factual basis.¹⁶⁵ A second way that plaintiffs can meet the pleading requirements of the PSLRA is by establishing scienter with circumstantial evidence of either reckless or conscious behavior.¹⁶⁶ The court defined a reckless statement as one “involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to defendant or is so obvious that the actor must have been aware of it.”¹⁶⁷ Thus, the type of recklessness required to prove scienter in the Section 14(e) context excludes ordinary negligence and instead approaches conscious deception.¹⁶⁸ In *Digital Island*, the court found that the plaintiffs’ allegations failed to create a strong

¹⁵⁷ *Id.* (quoting *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 10 (1985)).

¹⁵⁸ *Id.* (citing *Hochfelder*, 425 U.S. at 193).

¹⁵⁹ *Id.* The court cited an earlier Third Circuit case which adopted the same test of materiality for both Section 14(e) and Rule 10b-5. *Flynn v. Bass Bros. Enters.*, 744 F.2d 978, 984–85 (3d Cir. 1984).

¹⁶⁰ *See* 15 U.S.C. § 78u-4(b)(2) (2012).

¹⁶¹ *Id.*

¹⁶² *Digital Island*, 357 F.3d at 329 (quoting § 78u-4(b)(2)).

¹⁶³ *Id.* at 328–29.

¹⁶⁴ *Id.* at 328.

¹⁶⁵ *Id.* at 330–31. To establish a strong inference of motive, the plaintiffs would have had to “allege some facts tending to show how the Directors could have hoped to make out better by unloading their options and restricted stock than by realizing the impact of the Bloomberg and MLB deals on their shares, either in the market or in a merger with another suitor.” *Id.* at 331.

¹⁶⁶ *Id.* at 328–29.

¹⁶⁷ *Id.* at 332 (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999)).

¹⁶⁸ *Id.*

inference of recklessness.¹⁶⁹

Finally, the Eleventh Circuit joined the Second, Third, Fifth, and Sixth Circuits in holding that scienter is a necessary element for a Section 14(e) claim in the 2004 case *SEC v. Ginsburg*.¹⁷⁰ In *Ginsburg*, the SEC brought a civil action against Ginsburg alleging in part that he violated Section 10(b) and Section 14(e) of the Exchange Act when he provided material nonpublic information to his brother and father regarding two corporations, who subsequently used that information to trade on each corporation's stock.¹⁷¹ The court held that to establish liability under both Section 10(b) and Section 14(e) of the Exchange Act, the SEC must prove that Ginsburg "acted with scienter, a mental state embracing intent to deceive, manipulate, or defraud."¹⁷² In support of its holding, the court cited *SEC v. Adler*, a case involving alleged violations of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act.¹⁷³ Like the other circuits' ruling on a scienter requirement, the Eleventh Circuit appears to have relied on the common wording of Section 10(b)/Rule 10b-5 and Section 14(e) in arriving at its holding.

Circuits were consistent in requiring a showing of some form of scienter for Section 14(e) claims. This changed on April 20, 2018, when the Ninth Circuit held in *Varjabedian v. Emulex Corp.* that plaintiffs asserting claims under Section 14(e) of the Exchange Act need only show negligence, rather than scienter.¹⁷⁴ In reversing the district court's decision dismissing the complaint, the Ninth Circuit created the current circuit split surrounding the elements of Section 14(e) claims.

¹⁶⁹ *Id.* Since the plaintiffs' allegations showed that the defendants' interests were always tied to the value of their shares, the court found "no basis to infer the sort of conscious disregard and deliberate ignorance required to plead scienter." *Id.* At most, the plaintiffs' allegations proved some mismanagement, which does not fall within the anti-fraud prohibitions of Section 14(e). *Id.*

¹⁷⁰ 362 F.3d 1292, 1297 (11th Cir. 2004).

¹⁷¹ *Id.* at 1295. Ginsburg was the chairman and CEO of Evergreen Media Corporation. *Id.* at 1296. Evergreen became interested in acquiring EZ, so Ginsburg reached out to EZ's CEO and ultimately submitted a bid to acquire EZ. *Id.* The bid eventually fell through. *Id.* However, the SEC presented evidence that throughout the discussion between Evergreen and EZ, Ginsburg was communicating with his brother and father, and subsequent to those communications his brother and father would purchase large amounts of EZ stock. *Id.* This evidence suggested that Ginsburg was providing insider information to his brother and father for use to make trades. *Id.*

¹⁷² *Id.* at 1297 (citations omitted). This definition of scienter is identical to the Third Circuit's definition of scienter as established in *Digital Island*. *Digital Island*, 357 F.3d at 328.

¹⁷³ 137 F.3d 1325, 1327 (11th Cir. 1998).

¹⁷⁴ *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 401 (9th Cir. 2018), *cert. dismissed* 586 U.S. ___ (Apr. 23, 2019) (No. 18-459).

C. *The Ninth Circuit's Negligence Standard*

The Ninth Circuit considered the issue of whether Section 14(e) claims require proof of scienter in *Varjabedian v. Emulex Corp.*¹⁷⁵ The case involved a merger between Emulex Corp. and Avago Technologies Wireless Manufacturing, Inc.¹⁷⁶ In February 2015, the corporations issued a joint press release announcing that they had entered into a merger agreement.¹⁷⁷ The merger agreement provided that Emerald Merger Sub, Inc., a subsidiary of Avago, would initiate a tender offer for Emulex's outstanding stock on April 7, 2015.¹⁷⁸ A target corporation of a tender offer may issue a statement to the corporation's shareholders on whether to accept or reject the tender offer.¹⁷⁹ Emulex issued this recommendation statement to its shareholders.¹⁸⁰

Prior to issuing the recommendation statement to its shareholders, Emulex engaged Goldman Sachs for an opinion on the fairness of the merger agreement to the corporation's shareholders.¹⁸¹ Goldman Sachs provided Emulex with financial analyses supporting its opinion that the merger agreement was fair to the corporation's shareholders.¹⁸² Part of Goldman Sachs's financial analyses was a one-page chart that listed seventeen transactions in the industry that Goldman Sachs deemed most similar to the proposed merger between Emulex and Avago.¹⁸³ Goldman Sachs reviewed the premiums stockholders received in those similar transactions and determined that Emulex's 26.4% premium fell within the normal range of the premiums listed in the one-page chart.¹⁸⁴ However, Goldman Sachs found Emulex's premium to be below average when compared to the seventeen similar transactions.¹⁸⁵ Despite the below-average premium, Goldman Sachs concluded that the merger agreement was fair to Emulex's shareholders.¹⁸⁶

Emulex issued a statement to its shareholders recommending that they

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* at 402. A tender offer occurs where an offeror "seeks to obtain control of a target corporation . . . by publicly offering to purchase a specified amount of the target company's stock." *Id.* The target corporation's stockholders are asked to "'tender' their shares, at a fixed price, customarily in excess of the current market value, in order to gain control of the target company." *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 402–03.

¹⁸⁵ *Id.*

¹⁸⁶ *Id.* at 403.

accept the tender offer.¹⁸⁷ Emulex listed nine reasons for its recommendation, one being that Goldman Sachs found that the merger agreement was fair.¹⁸⁸ However, Emulex chose not to summarize the one-page chart in the recommendation statement, thus omitting the fact that Goldman Sachs found Emulex's premium below average in relation to the seventeen similar transactions.¹⁸⁹ Emulex's shareholders accepted the tender offer, and the merger commenced in May 2015.¹⁹⁰ The decision not to include Goldman Sachs' finding that the premium fell below average led to a class action by some of the shareholders against Emulex, Avago, Emerald, and Emulex's board of directors.¹⁹¹ The class of shareholders alleged that Emulex violated Section 14(e) of the Exchange Act when it failed to include the below-average premium, thereby misleading the shareholders for the purpose of accepting the tender offer.¹⁹²

The United States District Court for the Central District of California dismissed the plaintiff's complaint, following the authorities of the other circuits holding that Section 14(e) claims require proof of scienter.¹⁹³ The plaintiff appealed the district court's dismissal of the securities fraud claim, thereby allowing the Ninth Circuit to decide on the issue of whether Section 14(e) claims require proof of scienter for the first time.¹⁹⁴

The Ninth Circuit held in *Varjabedian* that Section 14(e) claims require a showing of negligence rather than scienter.¹⁹⁵ This decision led to the current circuit split regarding the elements of Section 14(e) claims. The Ninth Circuit supported a negligence standard by (1) using the plain language of the statute, (2) distinguishing between Rule 10b-5 and Section 14(e), (3) comparing Section 14(e) to Section 17(a) of the Securities Act, and (4) using the legislative history of the Williams Act.

¹⁸⁷ *Id.* at 402.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 403.

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *See Varjabedian v. Emulex Corp.*, 152 F. Supp. 3d 1226, 1233 (C.D. Cal. 2016) ("Considering the wealth of persuasive case law to the contrary, the Court concludes that the better view is that the similarities between Rule 10b-5 and § 14(e) require a plaintiff bringing a cause of action under § 14(e) to allege scienter."). The district court noted in its opinion that the Ninth Circuit had yet to address the issue of whether Section 14(e) claims require proof of scienter. *Varjabedian*, 888 F.3d at 401.

¹⁹⁴ *Varjabedian*, 888 F.3d at 401.

¹⁹⁵ *Id.*

1. *The Plain Language of Section 14(e)*

The Ninth Circuit first pointed to the plain language of the statute to support a negligence standard.¹⁹⁶ The court noted that Section 14(e) could be readily divided into two clauses, each of which prohibits different conduct:

It shall be unlawful for any person [1] to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, *or* [2] to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer¹⁹⁷

Accordingly, the Ninth Circuit reasoned that Congress used the word “or” to denote two separate offenses under the statute.¹⁹⁸ While the second clause prohibits fraudulent, deceptive, and manipulative acts, the court noted that the first clause must prohibit conduct other than fraudulent, deceptive, or manipulative acts.¹⁹⁹ The court reasoned that construing the statute otherwise “would render it ‘hopelessly redundant’ and would mean ‘one or the other phrase is surplusage.’”²⁰⁰ The use of the words “fraudulent,” “deceptive,” and “manipulative” in the second clause indicated to the court that the statute’s second clause required scienter.²⁰¹ Because the text of the first clause of Section 14(e) is devoid of any suggestion that scienter is required, and since the court believed that Congress wanted to avoid this redundancy, the court concluded that the first clause of Section 14(e) requires a showing of only negligence.²⁰²

2. *Differences Between Rule 10b-5 and Section 14(e)*

The Ninth Circuit was also unpersuaded by the reasoning of the five circuits that had required proof of scienter.²⁰³ The court noted that “the decision from these five circuits rest on the shared text found in both Rule 10b-5 and Section 14(e).”²⁰⁴ However, the court concluded that there are key distinctions between Rule 10b-5 and Section 14(e) which “strongly mitigate against importing the scienter requirement from the context of Rule 10b-5 to Section 14(e).”²⁰⁵

¹⁹⁶ *Id.* at 404.

¹⁹⁷ *Id.* (emphasis added) (quoting 15 U.S.C. § 78n(e) (2012)).

¹⁹⁸ *Id.*

¹⁹⁹ *See id.*

²⁰⁰ *Id.* (quoting *Hart v. McLucas*, 535 F.2d 516, 519 (9th Cir. 1976)).

²⁰¹ *See id.*

²⁰² *Id.* at 408.

²⁰³ *See id.* at 405.

²⁰⁴ *Id.*

²⁰⁵ *Id.*

The first distinction between Rule 10b-5 and Section 14(e) discussed by the Ninth Circuit is based on the Supreme Court case *Ernst & Ernst v. Hochfelder*.²⁰⁶ In *Hochfelder*, the Supreme Court held that claims under Section 10(b) of the Exchange Act and Rule 10b-5 must allege scienter.²⁰⁷ However, the Supreme Court noted in its opinion that the language of Rule 10b-5(b),²⁰⁸ when viewed in isolation, “could be read as proscribing, respectively, any type of material misstatement or omission . . . whether the wrongdoing was intentional or not.”²⁰⁹ Consequently, the Ninth Circuit interpreted *Hochfelder* as acknowledging that the language of Rule 10b-5(b) could be read as imposing a negligence standard.²¹⁰

Because of the identical language between Rule 10b-5(b) and the first clause of Section 14(e),²¹¹ the Ninth Circuit reasoned that Section 14(e) could also be read as imposing a negligence standard.²¹² Further, the Ninth Circuit concluded that the Supreme Court’s holding in *Hochfelder* was based on the relationship between Rule 10b-5 and its authorizing statute, Section 10(b) of the Exchange Act, and not based on the text of Rule 10b-5.²¹³

The Ninth Circuit identified a second distinction between Rule 10b-5 and Section 14(e): The SEC is authorized to regulate a broader array of conduct under the latter.²¹⁴ The court noted that “[u]nder § 14(e), the SEC may prohibit acts not themselves fraudulent under the common law or § 10(b), if the prohibition is reasonably designed to prevent acts and practices that are fraudulent.”²¹⁵ Thus, concluding that Section 14(e) itself reaches only fraudulent conduct requiring scienter would be inconsistent with the SEC’s authority to prohibit “acts themselves not fraudulent.”²¹⁶

²⁰⁶ See *id.* (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976)).

²⁰⁷ *Hochfelder*, 425 U.S. at 193.

²⁰⁸ Rule 10b-5(b) states that “[i]t shall be unlawful . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . .” 17 C.F.R. § 240.10b-5(b) (2018).

²⁰⁹ *Varjabedian*, 888 F.3d at 405 (quoting *Hochfelder*, 425 U.S. at 212).

²¹⁰ *Id.*

²¹¹ See *supra* Part I.A.

²¹² Compare 17 C.F.R. § 240.10b-5(b), with 15 U.S.C. § 78n(e) (2012).

²¹³ *Varjabedian*, 888 F.3d at 405–06 (“Put simply, Rule 10b-5 requires a showing of scienter because it is a regulation promulgated under Section 10(b) of the Exchange Act, which allows the SEC to regulate only manipulative or deceptive devices. This rationale regarding Rule 10b-5 does not apply to Section 14(e), which is a statute, not an SEC Rule.”).

²¹⁴ *Id.* at 407.

²¹⁵ *Id.* (citing *United States v. O’Hagan*, 521 U.S. 642, 673 (1997)).

²¹⁶ *Id.*

3. *Similarities Between Section 17(a) of the Securities Act and Section 14(e)*

The Ninth Circuit further justified its holding by pointing out the similarities between Section 17(a)²¹⁷ of the Securities Act and Section 14(e) of the Exchange Act. Specifically, the Ninth Circuit relied on the Supreme Court's holding in *Aaron v. SEC* that Section 17(a)(2) does not require a showing of scienter.²¹⁸ The Ninth Circuit noted that Section 17(a)(2) of the Securities Act and the first clause of Section 14(e) of the Exchange Act contain almost identical language, both prohibiting “any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made ... not misleading.”²¹⁹ The court reasoned that because of this identical language between the two statutes and because the Supreme Court held that Section 17(a)(2) of the Securities Act does not require scienter, Section 14(e) might not require scienter either.²²⁰

Beyond their plain language, Section 17(a) of the Securities Act and Section 14(e) serve similar purposes—they both “govern disclosures and statements made in connection with an offer of securities”²²¹ This similarity is important in the overall evaluation because “statutes dealing with similar subjects should be interpreted harmoniously.”²²² The distinction between Section 17(a) of the Securities Act and Section 14(e) is the type of transaction that each statute regulates—the former applies to initial public offerings and the latter applies to tender offers.²²³

²¹⁷ Section 17(a) of the Securities Act governs the sale of securities through interstate transactions:

(a) It shall be unlawful for any person in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement (as defined in section 3(a)(78) of the Securities Exchange Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

§ 77q(a).

²¹⁸ *Varjabedian*, 888 F.3d at 406 (citing *Aaron v. SEC*, 446 U.S. 680, 696–97 (1980)).

²¹⁹ *Id.* Compare § 77q(a)(2), with § 78n(e).

²²⁰ See *Varjabedian*, 888 F.3d at 406.

²²¹ *Id.*

²²² *Id.* (quoting *Jonah R. v. Carmona*, 446 F.3d 1000, 1007 (9th Cir. 2006)).

²²³ *Id.*

4. *The Legislative History of the Williams Act*

Finally, the Ninth Circuit referred to the legislative history and purpose of the Williams Act in support of its holding that Section 14(e) requires a showing of negligence.²²⁴ The Senate Report on Section 14(e) stated that “[the] provision would affirm the fact that persons engaged in making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer are under an obligation to make full disclosure of material information to those with whom they deal.”²²⁵ Further, the purpose of the Williams Act is partly to ensure that public shareholders are not required to respond to a tender offer without first obtaining adequate information.²²⁶ Based on the legislative history of the statute, the Ninth Circuit concluded that “the Williams Act places more emphasis on the quality of information shareholders receive in a tender offer than on the state of mind harbored by those issuing a tender offer,” which supports a negligence standard.²²⁷

The Ninth Circuit ultimately ruled that “because the text of the first clause of Section 14(e) is devoid of any suggestion that scienter is required,” the first clause of Section 14(e) requires a showing of only negligence, not scienter.²²⁸ In so holding, the court criticized the rationale behind each of the five circuits that had previously announced a scienter requirement for Section 14(e) claims.²²⁹ Based on these four factors, the Ninth Circuit correctly split from the previous circuits’ precedent when it held that the correct standard of review was one of negligence and not scienter.

II. THE NEGLIGENCE APPROACH

As previously discussed, the federal judicial system had a longstanding history of requiring proof of scienter when alleging a Section 14(e) violation.²³⁰ Some of these holdings have been, in part, a product of district courts honoring the precedent of federal circuits and maintaining some consistency across the

²²⁴ *Id.* at 407–08.

²²⁵ *Id.* at 408 (quoting S. REP. NO. 90-510 (1968), as reprinted in 1968 U.S.C.C.A.N. 2811, 2821).

²²⁶ *Id.* (quoting *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975)).

²²⁷ *Id.*

²²⁸ *Id.* Because the district court based its holding on a scienter requirement, the court remanded the case to the district court for consideration based on a negligence standard. *Id.* Although this lessens the plaintiff’s burden, the plaintiff is still required to show that the defendants omitted a material fact which misled Emulex’s shareholders in connection with accepting the tender offer. The court noted that Emulex’s omission of the below-average premium would most likely not be considered a material fact, thus likely leading to a dismissal of the complaint again. *See id.*

²²⁹ *Id.* at 406.

²³⁰ *See supra* Part I.B.

federal courts.²³¹ Rather than point to the precedent of other circuits and the similar language in SEC-promulgated rules, the Ninth Circuit took a fresh look at Section 14(e) and made a compelling argument for a negligence standard.²³²

As a result of the textual interpretation of the statute, the legislative history behind Section 14(e)'s implementation, and due to both the differences between Section 14(e) and Rule 10b-5, as well as the similarities between Sections 14(e) and 17(a), this Part argues in support of a negligence standard for Section 14(e) liability claims. Section A discusses a textual interpretation of the statute, which breaks Section 14(e) down into two distinct clauses. Section B argues why the legislative history of the Williams Act supports a negligence standard. Section C discusses why courts should not use Rule 10b-5 when interpreting Section 14(e), considering the former is an SEC-promulgated rule based on authority granted by Congress, and the latter is a statute enacted by Congress itself. Finally, Section D argues that similarities between Section 17(a) of the Securities Act and Section 14(e) warrant extrapolation of the case law under Section 17(a) as precedent for a negligence standard.

A. *Textual Interpretation Through a Plain Reading of Section 14(e) Supports a Negligence Standard*

As identified by the Ninth Circuit in *Varjabedian*, a plain reading of Section 14(e) readily divides the statute into two clauses.²³³ First, the statute prohibits “any untrue statement of a material fact or ... [an omission of] any material fact necessary in order to make the statements made ... not misleading ...”²³⁴ Second, the statute prohibits “any fraudulent, deceptive, or manipulative acts or practices ...”²³⁵ The use of the word “or” dividing the two clauses suggests that the statute prohibits two different types of conduct in connection with tender offers.²³⁶ The first clause explicitly requires two elements: (1) the fact must be untrue or, if an omission, misleading, and (2) the fact must be material.²³⁷ Hence, Section 14(e) does not explicitly require plaintiffs to prove that the defendant knew they were making an untrue statement when alleging a violation under the

²³¹ See, e.g., *Varjabedian v. Emulex Corp.*, 152 F. Supp. 3d 1226, 1233 (C.D. Cal. 2016) (“Considering the wealth of persuasive case law to the contrary, the Court concludes that the better view is that the similarities between Rule 10b-5 and § 14(e) require a plaintiff bringing a cause of action under § 14(e) to allege scienter.”).

²³² See *supra* Part I.C.

²³³ *Varjabedian*, 888 F.3d at 404.

²³⁴ 15 U.S.C. § 78n(e) (2012).

²³⁵ *Id.*

²³⁶ *Varjabedian*, 888 F.3d at 404.

²³⁷ § 78n(e).

first clause of Section 14(e).²³⁸ Comparatively, the second clause explicitly requires some form of intentional wrongdoing, whether it be fraudulent, deceptive, or manipulative.²³⁹ At common law, one element necessary to establish fraud is that the defendant acted with scienter.²⁴⁰ This plain reading of the statute supports the theory that Section 14(e) prohibits two different types of conduct, each with its own requirements.

A holding that Section 14(e) requires proof of scienter fails to consider the fact that the statute can be divided into the two clauses identified above. When the statute is divided as such, it is apparent that the first clause prohibits conduct distinct from the second clause, which prohibits any third party from intentionally defrauding a target corporation's shareholders in connection with a tender offer.²⁴¹ The second clause appears to demand proof of scienter based on the use of the words "fraudulent," "deceptive," and "manipulative."²⁴² In contrast, the first clause of Section 14(e) is devoid of any words that evince a scienter requirement.²⁴³ The plain language of this part of the statute "does not require that the prohibited statements or omissions be made knowingly or with the intent to deceive or defraud."²⁴⁴

An example is useful to showcase how different interpretations of Section 14(e) might play out in a hypothetical case. Imagine that AT&T makes a tender offer to Time Warner Inc.'s stockholders, offering to pay \$55 per share if at least 80% of the outstanding stock is tendered to AT&T by Time Warner's stockholders. Time Warner's board of directors evaluates the offer and determines that it is in the best interest of the stockholders to reject the offer. In its letter to the stockholders recommending that they reject AT&T's offer, the board omits the fact that Time Warner just lost its biggest client and will be experiencing a significant decline in revenues. Assume that a court would find Time Warner's upcoming drop in revenues to be material. This would constitute an omission of a material fact by Time Warner's board. If this case were heard in a circuit requiring scienter, then the corporation's stockholders would have to prove that the board knowingly and intentionally omitted this fact from its letter to the stockholders to defraud, deceive, or manipulate them into rejecting the

²³⁸ See Loewenstein, *supra* note 7, at 1331.

²³⁹ § 78n(e).

²⁴⁰ See, e.g., *Strategic Diversity, Inc. v. Alchemix Corp.*, 666 F.3d 1197, 1210 n.3 (9th Cir. 2012); *Heitman v. Brown Grp., Inc.*, 638 S.W.2d 316, 319 (Mo. Ct. App. 1982).

²⁴¹ See *Varjabedian*, 888 F.3d at 404 (arguing that the statute can be readily divided to prohibit two types of conduct and that the first clause prohibits negligent acts).

²⁴² See § 78n(e).

²⁴³ See *id.*

²⁴⁴ Loewenstein, *supra* note 7, at 1331.

tender offer. It can be very difficult to prove that a defendant acted with a particular state of mind. This circuit is arguably ignoring the first part of Section 14(e), which only explicitly requires an omission of a material fact. Under the hypothetical situation, Time Warner's stockholders can prove that the board omitted a material fact from them.

On the other hand, imagine that this case was heard by a circuit that interpreted Section 14(e) as prohibiting two different types of conduct as dictated by its two clauses. The stockholders could claim one of the following, consistent with Section 14(e)'s two clauses: (1) the board was negligent in omitting a material fact, or (2) the board intentionally omitted the material fact to manipulate the stockholders into rejecting the tender offer. Therefore, the stockholders could successfully claim the necessary elements of the alleged Section 14(e) violation under the first clause and continue with the case. This would be true because the first clause of the statute provides no explicit requirement that plaintiffs must prove the defendant acted with sufficient culpability in connection with a tender offer when alleging a violation of Section 14(e).²⁴⁵

A scienter requirement limits liability to those whose conduct has been sufficiently culpable to justify such liability.²⁴⁶ Circuit courts are doing just that by imposing a scienter requirement on Section 14(e) claims. Some may argue that Congress has had over forty years to correct the courts' interpretation of Section 14(e) and that the failure to do so speaks for itself, a canon of statutory construction known as the legislative inaction/acquiescence canon.²⁴⁷ The acquiescence canon presumes that Congress approves of a judicial interpretation of a statute if it is aware of that interpretation and does not amend the statute.²⁴⁸ Although this canon has been given weight in other contexts, the acquiescence canon has been the subject of criticism because inaction is not dispositive of anything.²⁴⁹ One court stated that "[l]egislative inaction is a weak reed upon which to lean in determining legislative intent."²⁵⁰ Alternatively, if Congress wanted to require scienter, it would not have included the first clause of Section 14(e) because that conduct would fall within the second clause. The better argument is that Congress wanted Section 14(e) to cover mere negligent conduct with regard to tender offers.

²⁴⁵ *See id.*

²⁴⁶ *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir. 1973).

²⁴⁷ Jacob Scott, *Codified Canons and the Common Law of Interpretation*, 98 GEO. L.J. 341, 375 (2010).

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Berry v. Branner*, 421 P.2d 996, 998 (Or. 1966).

The presumption against redundancy also supports the premise that the statute prohibits two different types of conduct in connection with tender offers.²⁵¹ The presumption against redundancy requires each word in a statute to have independent meaning, and it requires refraining from interpretations that would render a word useless.²⁵² If, by the first clause of Section 14(e), “Congress intended to prohibit only those misstatements or omissions that were accompanied by an intent to deceive, or scienter, then the section is redundant because the acts and practices prohibited by the second clause include fraudulent misstatements and omissions.”²⁵³ When a court construes the statute as requiring proof of scienter, the court is rendering the first clause of Section 14(e) useless, having no real meaning or contribution to the statute as a whole. Some may argue that the first clause should merely be taken as an example of the fraudulent conduct prohibited by the second clause. Yet a better interpretation of Section 14(e) would give meaning to the first clause of the statute as opposed to rendering it surplusage. Accordingly, scienter cannot be a necessary element of the first clause of Section 14(e) if the two clauses were to have independent significance.²⁵⁴

B. The Legislative History of the Williams Act Supports a Negligence Standard

The assertion that Section 14(e) requires a showing of negligence, rather than scienter, is also supported by general considerations of the legislative history and purpose of the Williams Act. Although its legislative history is not extensive and never specifically mentions a scienter or negligence standard, there is some indication that the first clause of Section 14(e) did not intend anything regarding the defendant’s state of mind.

One piece of history that supports a negligence standard comes from the Senate Report of the bill:

Proposed subsection (e) would prohibit any misstatement or omission of material fact, or any fraudulent or manipulative acts or practices, in connection with any tender offer This provision would affirm the fact that persons engaged in making or opposing tender offers ... are under an obligation to make full disclosure of material information to

²⁵¹ The presumption against redundancy is one of many canons of statutory construction used when interpreting the meaning of a statute. *See Varjabedian v. Emulex Corp.*, 888 F.3d 399, 404 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459); Scott, *supra* note 247, at 363.

²⁵² *Varjabedian*, 888 F.3d at 404; Scott, *supra* note 247, at 363.

²⁵³ Loewenstein, *supra* note 7, at 1335.

²⁵⁴ *Id.* at 1335–36.

those with whom they deal.²⁵⁵

The Senate Report separates the prohibition against misstatements and omissions from the prohibition against fraudulent activity.²⁵⁶ Further, it gives no indication that the misstatements and omissions had to be made knowingly or with any specific mental state.²⁵⁷ The Senate Report also addresses the overall legislative concern for full and fair disclosure.²⁵⁸ That concern for adequate disclosure would support the theory that the first clause of the statute requires less than an allegation of scienter because it “appears to require the affirmative disclosure of material facts of the nature enumerated in the specific tender offer disclosure provisions of the Williams Act.”²⁵⁹ Instead of proscribing intentional wrongdoings, that part of the statute is “directed toward instances of inadequate disclosure, whether in the form of affirmative misrepresentations, half-truths, or total nondisclosure.”²⁶⁰

Additionally, a 1970 amendment to Section 14(e) indicates that “the separate operation of the clauses was congressionally contemplated.”²⁶¹ The amendment added the last sentence of Section 14(e), giving the SEC rulemaking power to “define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.”²⁶² The amendment does not mention material misstatements and omissions, but rather reproduces the language in the second clause of Section 14(e).²⁶³

Further, the House Report describing the rulemaking authority in the amendment draws a clear distinction between false statements covered by the first clause of Section 14(e) and fraudulent or deceptive practices prohibited by the second clause: “The section would amend [Section 14(e)] of the Securities Exchange Act, which prohibits [1] false *statements and* [2] fraudulent or deceptive *practices* It would grant to the Commission rulemaking power to ... prevent fraudulent, deceptive and manipulative *practices*”²⁶⁴ It follows

²⁵⁵ S. REP. NO. 90-550, at 10–11 (1968), as reprinted in 1968 U.S.C.C.A.N. 2811, 2812; see also Loewenstein, *supra* note 7, at 1336.

²⁵⁶ Loewenstein, *supra* note 7, at 1336.

²⁵⁷ *Id.*

²⁵⁸ See S. REP. NO. 90-550, at 10–11; see also Habenicht, *supra* note 15, at 754.

²⁵⁹ Habenicht, *supra* note 15, at 736.

²⁶⁰ *Id.* at 737.

²⁶¹ See *id.* at 738.

²⁶² 15 U.S.C. § 78n(e) (2012).

²⁶³ See *id.*

²⁶⁴ H.R. REP. NO. 91-1655, at 6 (1970), as reprinted in 1970 U.S.C.C.A.N. 5025, 5030 (emphasis added); see Habenicht, *supra* note 15, at 738. The SEC also drew a distinction between the two clauses, stating prior to the amendment that “section 14(e) prohibits false *statements and* fraudulent or deceptive *practices* in connection with tender offers, but does not specifically grant the Commission any rulemaking authority to deal with such

that the operation of the amendment—its language inferring a scienter requirement—is restricted to the second clause of Section 14(e).²⁶⁵

The House Report on the 1970 amendment indicates that the purpose of the addition was “to allow the Commission to deal more effectively with the devices sometimes employed on both sides in contested tender offers.”²⁶⁶ These devices contemplated by the addition, and thus by the second clause of the statute, include “phony mergers” and “manipulations of market price during the offering period,” not the executives’ duty to disclose all material information to shareholders as contemplated by the first clause.²⁶⁷ With this amendment, Congress gave the SEC power to implement the second clause’s prohibition of deceptive acts and practices.²⁶⁸ Both Congress and the SEC appeared to acknowledge this difference in the scope of the first and second clauses of Section 14(e) and, “consistent with a theory of separability for the purpose of determining standards of liability, left the prohibition of misstatements and omissions of material facts unaffected by the scienter language in the amendment.”²⁶⁹

A negligence standard is further supported by the many references to proxy rules and regulations in the legislative history of the Williams Act.²⁷⁰ Although most lower courts referenced Rule 10b-5 and Section 10(b) when interpreting the requirements of Section 14(e),²⁷¹ the legislative history of the Williams Act indicates that Section 14(e) is more appropriately construed with reference to the proxy rules and regulations.²⁷² One statement made by the Williams Act’s principal sponsor during debates on the floor of the Senate provides support for the apparent relationship between the tender offer provisions of the Williams Act and the proxy rules.²⁷³ Senator Williams stated that “what this bill would do is to provide the same kind of disclosure requirements which now exist, for example, in contests through proxies for controlling ownership in a company This legislation is patterned on the present law and the regulations which govern proxy contest.”²⁷⁴ Other references in the legislative history of the Williams Act,

practices.” H.R. REP. NO. 91-1655, at 10 (emphasis added).

²⁶⁵ Habenicht, *supra* note 15, at 738.

²⁶⁶ H.R. REP. NO. 91-1655, at 4.

²⁶⁷ Habenicht, *supra* note 15, at 738.

²⁶⁸ *Id.* at 739.

²⁶⁹ *Id.*

²⁷⁰ Loewenstein, *supra* note 7, at 1337.

²⁷¹ *See supra* Part I.B.

²⁷² Loewenstein, *supra* note 7, at 1337.

²⁷³ *Id.*

²⁷⁴ 113 CONG. REC. 24,665 (1967). During the Senate debate, Senator Jacob Javits stated that Senator Harrison Williams “represents to the Senate, and I accept his representation fully, that this [bill] is analogous to

including language in the House Report²⁷⁵ and a statement by then-SEC Chairman Manuel Cohen,²⁷⁶ suggest that the scope of disclosure required by the tender offer provisions of the Williams Act was patterned after the rules governing proxy solicitation. This assertion is supported by the similarity of the underlying shareholder activity protected—“both tender offers and proxy contests involve a decision by shareholders on the future composition of management.”²⁷⁷ Additionally, both provisions are “designed to insure that target shareholders receive enough information to make such choices intelligently.”²⁷⁸ In each situation, “the effect of a potential change in management and control is crucial to the investor’s decision.”²⁷⁹ It makes sense

the proxy rules, so that very much the same principles obtain as to what the British call a takeover, as to a proxy fight by a group of stockholders.” *Id.*

²⁷⁵ The House Report accompanying the Williams Act included the following language:

The cash tender offer is similar to a proxy contest, and the committee could find no reason to continue the present gap in the Federal securities laws which leaves the cash tender offer exempt from disclosure provisions This bill is designed to make the relevant facts known so that shareholders have a fair opportunity to make their decision.

H.R. REP. NO. 90-1711, at 4 (1968), *as reprinted in* 1968 U.S.C.C.A.N. 2811, 2813.

²⁷⁶ At the House Hearings on the Williams Act, Chairman Cohen noted:

The procedures provided by the bills in the case of contested tender offers are analogous to those now followed when contending factions solicit proxies under the Commission’s proxy rules. These rules ... are generally accepted as having been successful in providing adequate and accurate information to shareholders in contests for control of their companies. While there are obvious differences between tender offers and proxy contests, there is in both situations the common element of concern with the future management and control of the company. Adequate material information is equally important to a shareholder who is faced with a decision whether to sell his securities or retain his investment in the company.

Takeover Bids: Hearings on H.R. 14475 and S. 510 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate & Foreign Commerce, 90th Cong. 13 (1968).

²⁷⁷ Habenicht, *supra* note 15, at 751.

²⁷⁸ *Id.*

²⁷⁹ *Id.* at 751–52. In the House Hearings, SEC Chairman Cohen noted:

It is argued by some that the basic factor which influences shareholders to accept a tender offer is the adequacy of the price. But ... how can an investor evaluate the adequacy of the price if he cannot assess the possible impact of a change in control? Certainly without such information he cannot judge its adequacy by the current or recent market price. That price presumably reflects the assumption that the company’s present business control and management will continue.

Takeover Bids: Hearings on H.R. 14475 and S. 510 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate & Foreign Commerce, 90th Cong. 13 (1968). The future of management is one consideration that all investors evaluate in making investment decisions. In the context of a proxy contest, a shareholder makes her investment decision when she casts her vote for or against incumbent management. In the tender offer context, a target shareholder makes a similar investment decision when she determines whether she will tender her shares to the offeror. Thus, “[e]qual protection should be afforded shareholders making these analogous investment decisions, under the corresponding antifraud provisions, Rule 14a-9 and § 14(e).” Habenicht, *supra* note 15, at 752 n.100.

to interpret statutes and rules on tender offers consistent with interpretations of proxy rules considering tender offers and proxy contests are two ways of achieving the same goal—gaining control of a company.

Rule 14a-9, the proxy anti-fraud provision, is of particular significance to this comparison:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is *false or misleading with respect to any material fact*, or which *omits to state any material fact* necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.²⁸⁰

Rule 14a-9 has language identical to the first clause of Section 14(e), both prohibiting misstatements and omissions of material facts within their respective methods of gaining control of a company.²⁸¹ Rule 14a-9 and the first clause of Section 14(e) each impose a duty of disclosure on persons engaged in activities contemplated within the respective provisions, and “the proper standard for imposing liability under either ... [provision] will depend on the nature and extent of this duty of disclosure, and the degree of care necessary for its satisfaction.”²⁸² In private damage actions for alleged violations of Rule 14a-9, courts generally have not required a showing that the defendant acted with scienter.²⁸³ Courts have agreed that the duty of disclosure will not be satisfied, and liability may attach, when a defendant has made statements which he should

²⁸⁰ 17 C.F.R. § 240.14a-9 (2018) (emphasis added).

²⁸¹ Compare 15 U.S.C. § 78n(e) (2012), with 17 C.F.R. § 240.14a-9.

²⁸² Habenicht, *supra* note 15, at 750 (citing *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir. 1973)). In *White v. Abrams*, the Ninth Circuit agreed with the assertion that the proper standard for imposing liability depends on the extent of the duty of disclosure owed to shareholders but determined that a further requirement of scienter was unnecessary, stating that it was “unfortunate that the Second Circuit attempted to limit this duty by requiring some degree of scienter or culpability and holding that mere negligent conduct would not be sufficient for liability.” 495 F.2d 724 (9th Cir. 1974).

²⁸³ *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 777–78 (3d Cir. 1976) (“[S]ection 14(a) and Rule 14a-9(a) may be more closely analogized to section 11 of the Securities Act of 1933 Since section 11 of the Securities Act clearly establishes negligence as the test for determining liability, the parallel ... strongly support[s] adoption of negligence as the standard under section 14(a).”); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1300–01 (2d Cir. 1973) (“[W]here the plaintiffs represent the very class who were asked to approve a merger on the basis of a misleading proxy statement and are seeking compensation from the beneficiary who is responsible for the preparation of the statement, they are not required to establish any evil motive or even reckless disregard of the facts.”).

have known were materially false or misleading—that is, when the defendant acted *negligently* in misstating material facts.²⁸⁴ The similarity of both purpose and intended effect in Rule 14a-9 and Section 14(e), together with their nearly identical language, “may warrant extrapolation of the case law under Rule 14a-9 as precedent for a negligence standard” under the first clause of Section 14(e).²⁸⁵

C. *Inappropriate Use of Section 10(b) and Rule 10b-5 to Interpret Section 14(e)*

As discussed in Part I.B, most lower courts imported the scienter requirement from the context of Rule 10b-5 to Section 14(e),²⁸⁶ largely due to the similar language of the two provisions.²⁸⁷ However, there are fundamental differences between Rule 10b-5 and Section 14(e), some identified by the Ninth Circuit in *Varjabedian*, that strongly undercut the argument for a scienter requirement.²⁸⁸

To understand the scope and limitations of Rule 10b-5, a court must look to the scope of its authorizing statute, Section 10(b).²⁸⁹ In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that Section 10(b) mandates a scienter requirement.²⁹⁰ The Supreme Court found several grounds for requiring proof of scienter. First, the plain meaning of the language of Section 10(b), specifically its use of the terms “manipulative,” “device,” and “contrivance,” evinced a congressional intent to proscribe only “knowing or intentional misconduct.”²⁹¹

²⁸⁴ See, e.g., *Gerstle*, 478 F.2d at 1300–01. In ruling that negligence was the appropriate standard for Rule 14a-9 allegations, the court noted differences between Section 14(a) compared to Section 10(b) and Rule 10b-5. First, the court noted that rather than emphasizing a prohibition of fraudulent activity, Section 14(a) indicates a congressional concern with “protection of the outsider whose proxy is being solicited.” *Id.* at 1299. Second, the court noted that although a negligence standard in Rule 10b-5 would undercut the express civil liability provisions of the securities laws, “a reading of Rule 14a-9 as imposing liability without scienter ... is completely compatible with the statutory scheme.” *Id.* Third, the court noted that a negligence standard would “serve to reinforce the high duty of care owed by a controlling corporation to minority shareholders in the preparation of a proxy statement” *Id.* at 1300. In contrast, the court noted that allowing a negligence standard under Rule 10b-5 would deter the significant corporate policy of publicly disclosing important business and financial developments. *Id.* These differences between Section 14(a) and Section 10(b) and Rule 10b-5 are “equally applicable to a comparison of Section 14(e) and Rule 10b-5.” Loewenstein, *supra* note 7, at 1338; see also *infra* Part II.C.

²⁸⁵ Habenicht, *supra* note 15, at 750.

²⁸⁶ See *supra* Part I.B.

²⁸⁷ See *supra* Part I.B.

²⁸⁸ See *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 407 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459).

²⁸⁹ 15 U.S.C. § 78j(b) (2012).

²⁹⁰ 425 U.S. 185, 193 (1976).

²⁹¹ *Id.* at 197–99.

Contrary to Section 10(b), Section 14(e) is not limited to terms that demonstrate an intent to prohibit only intentional wrongdoing.²⁹² Section 14(e) also proscribes any untrue statements of material fact without explicitly requiring that those untrue statements be made with sufficient culpability.²⁹³

The Supreme Court also found support in the overall statutory scheme of the federal securities law in holding that Section 10(b) mandates a scienter standard.²⁹⁴ In *Hochfelder*, the Supreme Court referred to several differences between Section 10(b) and certain provisions of the Securities Act.²⁹⁵ First, because the language of Section 11 of the Securities Act differs from the language of Section 10(b), and because Section 11 does not impose a scienter requirement, the Supreme Court noted that Section 10(b) must require scienter.²⁹⁶ Additionally, the Supreme Court recognized that Congress imposed significant procedural safeguards to combat the effect of the express civil remedy provisions of the Securities Act allowing recovery for negligent conduct, but that no such safeguards exist for allegations of Section 10(b).²⁹⁷ As such, the Supreme Court concluded that extending Section 10(b) to cover negligent conduct would conflict with congressional intent because “such extension would allow causes of action covered by §§ 11, 12(2), and 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.”²⁹⁸

With regard to Rule 10b-5, the Supreme Court in *Hochfelder* noted that when viewed in isolation, the language of Rule 10b-5(b) “could be read as proscribing ... any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not.”²⁹⁹ However, this interpretation of Rule 10b-5, implying that it also governs negligent conduct, would conflict with the prevailing interpretation of Section 10(b), which must require scienter to preserve the overall statutory scheme of the federal securities law. Since the SEC’s rulemaking power was limited by the scope of its statutory authority, the Supreme Court held that Rule 10b-5 must likewise be restricted to conduct involving scienter.³⁰⁰ Section 14(e), on the other hand, operates under no such

²⁹² Compare § 78n(e), with § 78j(b).

²⁹³ See § 78n(e).

²⁹⁴ *Hochfelder*, 425 U.S. at 206–11.

²⁹⁵ See *id.*

²⁹⁶ *Id.*

²⁹⁷ *Id.* at 209–10.

²⁹⁸ *Id.* at 210.

²⁹⁹ *Id.* at 212.

³⁰⁰ *Id.* at 210–12.

constraints.

While Rule 10b-5 is an SEC-promulgated rule circumscribed by the provisions of its authorizing statute Section 10(b), Section 14(e) is itself congressionally promulgated and is therefore subject to no similar limitation.³⁰¹ Section 10(b) does not contain language proscribing untrue statements of material fact like the language that appears in disclosure provisions such as Section 14(e).³⁰² Instead, Section 10(b) only prohibits the use of “manipulative or deceptive” devices and grants the SEC the power to “prescribe [rules and regulations] as necessary or appropriate in the public interest or for the protection of investors.”³⁰³ Because Rule 10b-5 was promulgated pursuant to the power granted in Section 10(b), the statute is a limitation on the operation of the rule. Since Section 14(e) is not limited in the same manner as Rule 10b-5, the contention that a scienter standard must be read into Rule 10b-5(b) because Section 10(b) claims require proof of scienter is inapplicable to Section 14(e).³⁰⁴ Similarly, courts are not bound by the precedent imposing a scienter standard for Rule 10b-5 in its entirety when evaluating allegations of Section 14(e) violations.³⁰⁵

The above factors, which contributed to the Supreme Court’s holding that Section 10(b) requires proof of scienter, are not applicable to Section 14(e). The language of the first clause of Section 14(e) is not consistent with the language of Section 10(b).³⁰⁶ Rather, the first clause of Section 14(e) is identical to Rule 10b-5(b),³⁰⁷ which the Supreme Court in *Hochfelder* acknowledged could be read as covering negligent conduct.³⁰⁸

D. A Comparison of Section 17(a) and Section 14(e) Supports a Negligence Standard

Although the Supreme Court has yet to resolve the dispute over whether scienter or negligence is the appropriate standard under Section 14(e), there is some support for a negligence standard in Supreme Court case law. As discussed in Part II.C, *Hochfelder* may be used as support for a negligence standard because the Supreme Court acknowledged that the nearly identical language in

³⁰¹ Compare 17 C.F.R. § 240.10b-5(b) (2018), with 15 U.S.C. § 78n(e) (2012).

³⁰² Compare § 78n(e), with § 78j(b).

³⁰³ § 78j(b).

³⁰⁴ Habenicht, *supra* note 15, at 747–48.

³⁰⁵ *Id.* at 748.

³⁰⁶ Compare § 78n(e), with § 78j(b).

³⁰⁷ Compare 15 U.S.C. § 78n(e), with 17 C.F.R. § 240.10b-5(b) (2018).

³⁰⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976).

Rule 10b-5 may be read as prohibiting conduct beyond intentional wrongdoing.³⁰⁹ Additionally, the similarities in both language and purpose of Section 17(a) of the Securities Act and Section 14(e) may warrant putting precedential value on the Supreme Court's holding in *Aaron v. SEC* that Section 17(a)(2) does not require proof of scienter.³¹⁰

Aaron may be used as precedent to support a negligence standard under Section 14(e) because of the statute's nearly identical language to Section 17(a). Both statutes prohibit "any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made ... not misleading."³¹¹ Additionally, both statutes prohibit intentional conduct that requires more than mere negligence.³¹² In holding that Section 17(a)(2) does not require scienter, the Supreme Court in *Aaron* looked at the plain language of the statute.³¹³ Although the terms in Section 17(a)(1) evince a clear congressional intent to require scienter, Section 17(a)(2) is devoid of any indication of a scienter requirement.³¹⁴ Likewise, Congress evinced a clear congressional intent to require scienter under the second clause of Section 14(e) by using the terms "fraudulent," "deceptive," and "manipulative."³¹⁵ Yet the first clause of Section 14(e) is devoid of any indication of a scienter requirement, much like Section 17(a)(2).³¹⁶

The Supreme Court in *Aaron* explicitly rejected the suggestion that there should be a uniform culpability requirement for Section 17(a) because the language of the statute is not amenable to that interpretation.³¹⁷ The Supreme Court noted that each subparagraph of Section 17(a) "proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections."³¹⁸ Even though Congress more illustratively broke out the prohibited conduct in Section 17(a) into subparagraphs,³¹⁹ Congress distinguished the two different types of conduct prohibited by Section 14(e) with the use of the word "or"

³⁰⁹ See *supra* Part II.C.

³¹⁰ 446 U.S. 680, 696–97 (1980).

³¹¹ Compare § 77q(a)(2), with § 78n(e).

³¹² Compare § 77q(a)(1), with § 78n(e).

³¹³ *Aaron*, 446 U.S. at 696.

³¹⁴ *Id.*

³¹⁵ See *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 412 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459).

³¹⁶ *Id.*

³¹⁷ *Aaron*, 446 U.S. at 697.

³¹⁸ *Id.*

³¹⁹ 15 U.S.C. § 77q(a) (2012).

separating the two clauses.³²⁰ This similarity provides further support for importing a negligence standard on Section 14(e).

The Supreme Court further recognized that since Congress apparently drafted Section 17(a) to compel the conclusion that scienter is required under Section 17(a)(1) but not under Section 17(a)(2), “it would take a very clear expression in the legislative history of congressional intent to the contrary to justify the conclusion that the statute does not mean what it so plainly seems to say.”³²¹ The Supreme Court found no such contrary congressional intent in the legislative history of Section 17(a).³²² Consequently, under *Aaron*, there would have to be a clear expression in the legislative history of the Williams Act of congressional intent to require scienter under Section 14(e) in its entirety.³²³ There is no such congressional intent in the legislative history of Section 14(e), as discussed in Part II.B.³²⁴

Beyond their plain language, Section 17(a) and Section 14(e) serve similar purposes—they both “govern disclosures and statements made in connection with an offer of securities”³²⁵ This similarity is important in the overall evaluation because “statutes dealing with similar subjects should be interpreted harmoniously.”³²⁶ The distinction between Section 17(a) and Section 14(e) is the context—the former applies to initial public offerings, and the latter applies to tender offers.³²⁷

There is much support for finding a negligence standard under Section 14(e). A plain reading of the statute readily divides it into two separate clauses, one of which suggests a negligence standard and the other requiring scienter.³²⁸ The legislative history of the Williams Act also suggests that Congress intended Section 14(e) to require less than a showing of scienter.³²⁹ Although courts have used Rule 10b-5 when interpreting Section 14(e), it is inappropriate to use an SEC-promulgated rule, restricted by its authorizing statute, to interpret a statute promulgated by Congress itself and subject to no such restrictions.³³⁰ A better

³²⁰ *Id.* § 78n(e).

³²¹ *Aaron*, 446 U.S. at 697.

³²² *Id.*

³²³ *See id.*

³²⁴ *See supra* Part II.B.

³²⁵ *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 406 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459).

³²⁶ *Id.* (quoting *Jonah R. v. Carmona*, 446 F.3d 1000, 1007 (9th Cir. 2006)).

³²⁷ *Id.*

³²⁸ *See supra* Part II.A.

³²⁹ *See supra* Part II.B.

³³⁰ *See supra* Part II.C.

comparison would be to Section 17(a) of the Securities Act, which does not require proof of scienter and has language and purpose similar to that of Section 14(e).³³¹

III. IMPLICATIONS OF THE PROPOSED NEGLIGENCE STANDARD

The scienter approach has facilitated a corporate culture in which company executives can put their own interests ahead of shareholders' interests without facing allegations that they violated securities laws. Implementing a negligence standard would place a much-needed spotlight on how these executives handle third-party takeovers. A negligence standard would also have various implications on this country's judicial system. Since shareholders could more easily prove a violation of Section 14(e), there would be an increase in claims asserted against a company's top executives. Because a negligence standard would place a company's top executives at a higher risk of these claims being asserted against them, a negligence approach could create positive change toward executives focusing more on shareholders' interests than on their own interests when evaluating tender offers.

One major implication of a negligence standard is that shareholders would have an easier time asserting a violation of Section 14(e). A shareholder would only have to prove that an executive made an untrue statement of material fact or misled them by omitting a material fact. Unlike a scienter requirement, a negligence standard does not require the shareholder to go into the mind of the executive. Mere negligence can result without any intentional wrongdoing at all, but rather by the failure to act with the duty of care necessarily required by the company's executive. While this looser standard might concern some, it does not follow that the standard would place unfair and unwarranted liability on innocent executives. These executives should be well aware that their primary responsibility lies with the shareholders. They are hired to represent the shareholders' best interests and to make business decisions that will positively impact those interests.

Moreover, a negligence standard does not mean that shareholders would be able to successfully allege a violation of Section 14(e) on every occasion. One major safeguard protecting company executives from potential liability is the requirement that an alleged untrue statement or omitted fact be *material*.³³² Not every fact is of consequence. To be material, the shareholders must prove that they would have arrived at a different conclusion had the executives not made

³³¹ See *supra* Part II.D.

³³² See 15 U.S.C. § 78n(e) (2012) (emphasis added).

the untrue statement, or had the executives not omitted the fact. The facts of *Varjabedian* serve as a useful example. In that case, the shareholders alleged that they were misled by Emulex and its executives when they failed to disclose Goldman Sachs's finding that Emulex's premium was below average compared to similar mergers.³³³ Despite this fact, Goldman Sachs still opined that the merger was fair to the shareholders, and that opinion was communicated in Emulex's recommendation letter to its shareholders without the full report by Goldman Sachs.³³⁴ Although the Ninth Circuit did not answer whether the omission of the below-average premium was material, the court noted that it would be difficult for the shareholders to prove that the omission was indeed material.³³⁵ The shareholders would have to prove that had they known Emulex's premiums fell below average, they would have rejected the tender offer.

In addition to the potential impact that a negligence standard would have on the judicial system, it could also affect the way company executives approach their jobs. Executives owe a duty of care to the shareholders, which requires them to act in accordance with the shareholders' best interests when making business decisions. However, one can imagine a situation in which a company's shareholders receive a tender offer, and the company's executives are torn between their duty to the shareholders and their own concerns. If the tender offer is technically fair and beneficial to the shareholders, then the executives should recommend that the shareholders accept it. However, the executives may begin to wonder if a change in control will mean a subsequent change in management. The executives may grow concerned about the safety of their positions and the future of the company. A negligence standard under Section 14(e) contemplates a broader range of conduct, which would likely ensure that executives are more cautious when communicating material information to the shareholders. A negligence standard would more strongly encourage executives to act in accordance with the shareholders' interests instead of their own.

CONCLUSION

Securities fraud laws provide shareholders with the comfort they need to make smart investment decisions that align with their best interests. Specifically, Section 14(e) of the Exchange Act guarantees that shareholders are accurately informed of all the information material to them when evaluating tender offers.

³³³ *Varjabedian v. Emulex Corp.*, 888 F.3d 399, 403 (9th Cir. 2018), *cert. dismissed* 586 U.S. ____ (Apr. 23, 2019) (No. 18-459).

³³⁴ *Id.* at 402–03.

³³⁵ *Id.* at 408.

Unfortunately, circuit courts have been providing less protection to shareholders than might be mandated by Section 14(e), imposing a scienter requirement primarily based on the similar language between Section 14(e) and Rule 10b-5. This Comment criticized that approach and argued that the case law under Rule 10b-5 should carry no precedential weight in Section 14(e) claims.

Although the correct burden of proof under Section 14(e) remains unresolved by the Supreme Court, this Comment argued that the appropriate approach to Section 14(e) claims is a negligence standard. Both a plain reading of the statute and the legislative history of the Williams Act support a negligence standard. In the absence of clear congressional intent to the contrary, it follows that Section 14(e) allows for shareholders to allege mere negligence rather than requiring proof of scienter. The potential impact that a negligence standard would have on the judicial system and on company executives provides further support for the conclusion drawn. Ultimately, a negligence standard could provide additional assurance to shareholders that company executives are indeed acting in accordance with the shareholders' best interests.

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